VIA OVENIGHT MAIL

March 27, 2003

Kristi Izzo, Secretary
New Jersey Board of Public Utilities
Two Gateway Center
Newark, New Jersey 07102

RE: ATLANTIC CITY ELECTRIC D/B/A CONECTIV POWER DELIVERY COMMENTS ON THE FINAL REPORT AND AUDIT RECOMMENATIONS OF THE 2002 AFFILIATE RELATIONS AUDIT

BPU DOCKET NO.: EA02020095

Dear Secretary Izzo:

Enclosed is an original and ten (10) copies of the Company's comments on the Final Audit Report in the above matter. We have segregated our comments into two sections. Section I. includes the Company's specific comments for each audit report recommendation in corresponding order to the Summary of Recommendations as included in Section D. of the Final Report. Section II. contains general factual corrections to the Final Report. We would ask that the Board include a copy of the Company's filed comments with any copy of the Final Report that may be requested by and distributed to other parties.

Thank you for your attention in this matter.

Sincerely,

Roger E. Pedersen
New Jersey Regulatory Lead

c: Walter Szymanski (25 copies), Director, Division of Audits
Seema M. Singh, Esq., Ratepayer Advocate and Public Advocate Designee
John Antonuk, President Liberty Consulting
Internal Distribution

ATLANTIC CITY ELECTRIC D/B/A CONECTIV POWER DELIVERY COMMENTS ON THE FINAL REPORT AND AUDIT RECOMMENATIONS OF THE 2002 AFFILIATE RELATIONS AUDIT

BPU DOCKET NO. EA02020095

I. COMMENTS TO REPORT RECOMMENDATIONS

The following are the Company's comments on the Final Audit Report Recommendations:

Summary Recommendation 1
Treat ASP as an ACE holding company RCBS for purposes of applying the standards.

The Company will include ASP as a Retail Affiliate in future updates of its Compliance Plan.

Summary Recommendation 2
In combination with SJG, solicit bids for meter-reading services being provided by Millennium; if another vendor offers lower costs, then ACE should change contractors.

If the Board adopts this recommendation, the Company will comply, but would ask for a reasonable amount of time in which to conduct the solicitation of competitive bids.

Summary Recommendation 3
Charge for all work done for Millennium.

If the Board adopts this recommendation, the Company will comply.

Summary Recommendation 4
Submit a corrected Compliance Plan listing TELP as a holding company RCBS.

We agree that based on current information, TELP should be considered a Retail Affiliate. We will submit a correction to our Compliance Plan listing TELP *instead* of Conectiv Thermal Systems as a Retail Affiliate, because all NJ district heating and cooling business is through TELP, not through Conectiv Thermal.

Summary Recommendation 5
Update the Compliance Plan to reflect the addition of RCBSs as a result of the PEPCO merger.

The Company already filed an updated Compliance Plan with the New Jersey Board of Public Utilities on January 17, 2003, which included the addition of any RCBSs as a result of the Pepco/Conectiv merger.

Summary Recommendation 6
Reinforce in the Compliance Plan and clarify in guidance to employees the applicable restrictions on certain transactions between ACE and an RCBS of the holding company.

The Company can modify its next filed Compliance Plan to expand its guidance to employees on the applicable restrictions on transactions between ACE and a RCBS of the holding company.

Summary Recommendation 7
Revise the ACE Compliance Plan to provide direction to employees on how to implement and adhere to the Standards.

First, the Company believes this recommendation should be narrowed and clarified to refer to the specific Standard being addressed in this section of the report by the auditors. Therefore, the Company suggests that the Summary Recommendation read: "Revise the ACE Compliance Plan to provide direction to employees on how to implement and adhere to Section 14:4-5.3(a) of the Standards."

Although the Company believes that all employees are provided adequate instruction on how to adhere to the New Jersey Affiliate Relations Standards, the Company can modify its next filed Compliance Plan to include additional instruction and guidance concerning Section 14:4-5.3(a) of the Standards.

Summary Recommendation 8
Amend the ACE Compliance Plan Compliance Procedures on Section 14:4-5.3(n) either to prohibit the advice to customers about its PUHC RCBS, or to provide guidance to employees on what advice is appropriate and how that advice can be provided with regard to competitors.

The Company disagrees with this recommendation and has procedures and tools in place to provide guidance to employees on what advice is appropriate and how that advice can be provided to customers with regard to competitors. In particular, all Customer Service employees (as the primary point of contact for these types of issues) are advised of our "code of conduct" when they attend entry training. In addition, there is information out on LINK (our on-line job aid) to assist them in this area, which provides them with specific indexed definition of terms and specific indexed instruction on how to address issues and questions.

Summary Recommendation 9
Provide for regular verification that all database specific procedures, communications and training plans are adequate to assure full compliance with the access and security requirements of the Standards.

The Company believes that a policy is already in place to ensure that access to database information is adequately controlled. Currently, both Conectiv's and Pepco Holdings, Inc.'s web-sites contain information concerning the Code of Conduct. Specifically, Conectiv's web-site contains the actual NJ Code of Conduct, frequently asked questions concerning the Code, and a discussion on the expectation of each employee to comply with the Code of Conduct. As part of Conectiv's overall compliance program, each manager in the company is required to sign an Annual Certification Form. This form certifies that each manager has read the Code of Conduct (as well as other company policies) and has also discussed this information with his/her direct reports. The issue of sharing information, including electronic data, should be included in those discussions. No person is granted access to a database, or data, without the specific permission of the "owner" of (meaning the person responsible for) the database. The owner of the database is in the best position to determine what data is contained therein and who should be allowed access, taking into consideration applicable Codes of Conduct and other relevant criteria. Because of the annual certification process and the general company-wide awareness of the need to comply with the Codes of Conduct, we believe that database owners responsible for granting access have adequate knowledge of Code of Conduct issues and can exercise adequate control over data. However, we believe that adding a specific instruction to the IT security guidelines directing employees to visit the Conectiv web-site to ensure compliance with the NJ Code of Conduct is a worthwhile improvement to the policy and that an annual verification that these procedures, communications and training plans are adequate to assure full compliance with the access and security requirements of the Standards would be reasonable.

Summary Recommendation 10

Include in the Compliance Plan additional statements addressing the joint products and services requirements of Section 14:4-5.5(f).

The Company can modify its next filed Compliance Plan to include additional statements addressing the joint products and services requirements of Section 14:4-5.5(f).

Summary Recommendation 11

Adopt and enforce the requirement that indirect purchasing costs be captured in a fashion that will support their apportionment according to the amount of purchases made and make the apportionment of such indirect costs in that manner.

The Company does not agree with this requirement. It is the Company’s opinion that an allocation of indirect purchasing costs simply based on the dollar amount of purchases is not always a better allocation methodology. There are instances when a small dollar purchase item requires a significant amount of processing time by purchasing personnel, while a high dollar purchase item may only require minimal processing. In addition, the organization of the Company’s Supply Chain group has evolved over the last several years to better understand and segregate the type of work performed. The costs incurred for general corporate purchasing programs, such as office supply purchases and corporate travel and procurement programs, are captured in distinct cost centers in order to minimize any concerns over cross-subsidization of costs between the regulated and non-regulated businesses.

If the Board determines that it is appropriate to adopt this recommendation, the Company will comply, but would request a reasonable amount of time in which to do so.

Summary Recommendation 12
Include in the Compliance Plan and CAM compliant practices and procedures for the pricing of joint services.

The Company can include compliant practices and procedures for the pricing of joint services in future updates of the Compliance Plan. However, regarding the inclusion of such information in the Company's CAM, see the response to Recommendation 13.

Summary Recommendation 13
Modify the pricing procedures in the CAM to be consistent with the Standards.

The purpose of the Company's CAM is to document its standard costing methodology to be applied across all of the Conectiv companies. The CAM, in its current version, is a voluminous document and the Company must evaluate any recommendations that would increase the size of this document, weighing the need to provide guidance to employees via policies and procedures against creating a document that is too unwieldy and is not easily utilized by employees. In light of this, the Company has not had the opportunity to fully evaluate how Liberty's recommendation would impact the document. It should be noted that the Company's parent company (PHI) operates in six jurisdictions, all of which have adopted differing policies in regard to accounting for transactions for regulatory purposes. These differing "policies" are briefly discussed in the CAM. The CAM is used by employees as an accounting tool, in conjunction with other relevant documents, Board Orders and policies to address the Company's policies for accounting for transactions in order to permit the production of financial statements in accordance with generally accepted accounting principles (GAAP). The Company would suggest further evaluation of this recommendation and, if appropriate, would propose to address the intent of this recommendation in an alternative manner.

Summary Recommendation 14
Update the CAM to reflect current practices.

The Company can modify its next filed Compliance Plan to reflect current practices.

Summary Recommendation 15

Institute refresher training to ensure that the day-to-day accounting procedures (such as when an affiliate should pay its own invoice) are clearly understood and implemented.

Although the Company would disagree that accounting procedures are not clearly understood, we could institute refresher training to ensure that the day-to-day accounting procedures are clearly understood and implemented.

Summary Recommendation 16

Reduce dependence on general allocators by implementing a greater degree of direct charging.

The Company does require "positive" time reporting. As a result of the consummation of the Conectiv/PEPCO merger, the Company has renewed its efforts to educate employees on the proper tracking and recording of time for work performed for PHI and Conectiv companies. The use of appropriate charge numbers when completing time sheets has been part of this effort. This education has not only been for the benefit of new employees of the PHI Service Company (former PEPCO employees who are now service company employees), but also for the existing employees of Conectiv. An example of the education process is a link in the PEPCO Intranet page to a section on time reporting for the PHI Service Company.

In response to the specific recommendation for a greater degree of direct charging, there are some areas of the service company where the nature of the work is highly transactional (such as accounts payable and customer care) and the tracking of costs by separate company would likely be unwieldy or impractical. Also, in the case of these two groups, the allocation factor has been developed with a strong causal relationship (number of checks paid for accounts payable, and number of customers for customer care). Several other groups in the shared services areas of the service company perform a corporate governance function that affects, and benefits, most, if not all, of the companies within the Conectiv and PHI holding company system of companies. The use of detailed tracking mechanisms for time reporting by these groups would also likely be unwieldy or impractical.

Lastly, the comparison of audit test results for directly charged and allocated costs between various groups within the service company (such as the Delivery LOB and Energy LOB) is not appropriate due to the differing nature of the work performed by each group. In addition, there are further differences that exist between subgroups, or functions, within each group. The Company uses cost centers to help distinguish the nature of the work performed by service providers in CRP in order to assist in the charging of costs to affiliate companies.

Summary Recommendation 17
Develop and institute an A&G loader to be included in activity type prices used for direct charges. (i.e., Pension/OPEB, Human Resources "HR" and Accounts Payable "A/P").

Starting in 2003, the Company has included the cost of Pension and OPEB in activity type prices. The Company does not agree with the inclusion of additional A&G loaders for HR and A/P, as recommended by Liberty. The Company believes that the fully loaded activity type prices, as adjusted in 2003 for the inclusion of a Pension/OPEB loader, capture the costs related to an employee to perform his or her duties. The use of accounts payable processing is primarily utilized to conduct the operations of the business and is not directly related to the performance of an employee's duties. While an argument can be made that there are HR costs that can be directly linked to an employee being able to perform his or her job (such as payroll processing), these costs are not material. In addition, when considering the significant increased complexity of assigning HR costs to individual activity prices (and the related cost centers of the employees), the cost to implement this additional loader would likely outweigh the potential benefit from a higher activity type price.

In response to Liberty's specific example of the costs charged to Conectiv Energy Supply (CES), the Company does not believe it is appropriate to apply the same percentages calculated from the cost of services provided by the Energy LOB group to CES to the additional shared service groups. The costs that should be charged to CES for other shared services should be, and are, based on various factors, including the number of checks that CES requires from the A/P department and the number of employees employed by CES, in relation to the other Conectiv companies.

Summary Recommendation 18
Develop a method for capturing the indirect A&G costs in each cost center, so that any remaining costs that are allocated reflect the fully-loaded cost of that activity.

Based on the Company's response to recommendation #17, a Pension/OPEB loader has been developed and is being applied to each resource cost center (cost center with employees) as part of the monthly closing cycle, similar to the Benefit loader already applied to each resource cost center. No additional A&G loaders are proposed to be developed or applied to cost centers at this time.

Summary Recommendation 19
Reconcile for differences between budgeted and actual activity type prices.

The Company believes that it has adequate reconciliation procedures in place regarding activity type prices. As part of the Company's annual budget planning process, significant differences between budgeted and actual costs, as well as budgeted and actual productive hours, are considered in the development of activity type prices for the following year. This analysis is done at the resource cost center level, as part of the calculation process and is performed by the Corporate Accounting team as part of their review process when activity type price calculation workbooks are submitted.

In addition, the Corporate Accounting team has provided direction in the past to resource cost center analysts regarding the review of activity prices periodically during the year. Any necessary adjustments to activity type prices resulting from this review process are then entered into SAP by the Corporate Accounting team. The review process noted above involves the review of actual results, in terms of costs incurred and productive hours experienced, in conjunction with revised projections through year-end for both items. This process is normally performed late in the second quarter, at the earliest, due to the nature of the calculation of the activity type prices. The calculation is premised on a generally accepted accounting practice for the calculation of standard prices, which involves looking at costs and productive hours on an annualized basis to appropriately allow for seasonal variances. Productive time varies from season to season due to lost time items, such as holidays and vacations, as well as other items, such as overtime. In addition, incurred costs may be impacted by the timing of invoices received for processing. Fluctuations in the recording of costs and lost time or overtime are generally smoothed throughout the entire year to avoid the appearance of favoring one customer or company over another by constantly changing the standard activity prices.

However, if the Board determines that it is appropriate to adopt this recommendation, the time period (*i.e.*, on an annual basis?) for the reconciliation should be specified.

Summary Recommendation 20
Mandate that disclaimer required under Section 14.4-5.5(k) of the Standards be made on all materials circulated in New Jersey from any Conectiv RCBS that uses the Conectiv name and the "floating 'C'" logo, including faxes and e-mails, regardless of their purpose.

The Company agrees to include a disclaimer required under Section 14:4-5.5(k) of the Standards for materials circulated in New Jersey.

Summary Recommendation 21
Make the disclaimer required under Section 14.4-5.5(k) of the Standards on the website whenever a Conectiv Retail Affiliate is mentioned in juxtaposition with a discussion of utility service offerings in New Jersey.

Implementation will be problematic, since our web-site is not limited to New Jersey. In addition, the Company's web site is informational only and does not solicit new retail business in New Jersey. Any remaining customers of Retail Affiliates using the Conectiv name or logo in New Jersey are large, sophisticated commercial and industrial customers of Conectiv Energy Services, Inc. The large sophisticated business enterprises are not in need of disclaimer protections and do not purchase services by looking at the website. The Company believes it is unnecessary and inappropriate to include a disclaimer under these circumstances. However, the Company can include a disclaimer on any Web Page that mentions both Conectiv Power Delivery and a Conectiv Retail Affiliate in "juxtaposition" with each other <u>if and when we solicit new retail business to residential or small business customers in New Jersey.</u>

<u>Summary Recommendation 22</u>
Prepare and submit to the Board a report describing where Conectiv uses the disclaimer required under Section 14.4-5.5(k) of the Standards, and, when it is not used, its reasoning as to why it is omitted.

If the Board adopts this recommendation, the Company will comply, but would request a reasonable amount of time in which to do so.

<u>Summary Recommendation 23</u>
Amend the ACE Compliance Plan to specifically prohibit additional forms of joint advertising and marketing.

The Company agrees to modify its next filed Compliance Plan (1) to indicate that the reference (on page 21, footnote 34) is to billing or service-related information that third-party suppliers include when using the ACE/CPD invoice for billing the supply component, rather than to advertising, (2) to expand its interpretation/definition of "marketing" beyond what can be directly construed as solicitation or sale of products and services, to include the provision of any solicitation or advertising material containing information regarding products or services individually, or regarding product or service lines collectively, thus precluding any general branding or image advertising that includes material information about or descriptions of products and services offered by the utility and a Retail Affiliate in the same advertisement, and (3) to preclude Conectiv representatives from providing information about or descriptions of products and services offered by the utility and a Retail Affiliate, from the same booth at trade shows, conferences or other marketing events in New Jersey.

<u>Summary Recommendation 24</u>
In the event that the Board decides that clause (1) of Section 14:4-5.5(p) prohibits RCBS employees from being also involved in the provision of non-competitive utility and safety services, refrain from using any utility holding company RCBS to help maintain its utility infrastructure.

If the Board adopts this interpretation, the Company will comply.

Summary Recommendation 25
Reposition the duties of the individuals who serve as a Director or an Officer for both a utility and a related competitive business segment of the utility's holding company.

The Company maintains that this recommendation may represent a misreading of the requirement. The Company is not required to have Directors for ACE who are not also Directors of Retail Affiliates — instead, ACE and the Retail Affiliates are not allowed to have the same persons serving on the Board of Directors *as corporate officers.* Therefore, so long as none of ACE's directors, who are also directors of Retail affiliates are also officers of ACE, the Company is in compliance. Other than the "shared services" exception the Company noted in its Compliance Plan, none of ACE's directors who also serve on boards of Retail Affiliates are also officers. Therefore, assuming that the Company's interpretation that there is an exemption for officers who are shared services providers is not approved by the board, as long as the CFO of ACE is removed from the Board or the Company elects a new CFO who does not serve on the Board of ACE and any Retail Affiliate, the Company will be in compliance.

In the event the Board does not agree with this interpretation of the Standards, the Company states that it strongly believes that a common Board of Directors for all of its subsidiaries is necessary and appropriate to ensure proper corporate governance across all of its entities. It is the officers of the Company who have day-to-day operational responsibility. Therefore, since there are no ACE officers who are also officers or directors of Retail Affiliates, or on the Board of ACE, an appropriate amount of completely separate oversight to ensure that ACE is protected is in place. It should not be necessary to also require a separate Board of Directors and could be harmful to the efforts of the whole corporation to ensure proper corporate governance, which is essential in today's business and legal environment.

Summary Recommendation 26
Establish a procedure to ensure that ACE's employee transfer reporting obligations under Section 14:4-5.5(r) are met.

The Company has already instituted a procedure to ensure that ACE's employee transfer reporting obligations under Section 14:4-5.5 (f) are met. The Annual Employee Transfer Report for 2001 was filed with the NJ BPU on September 4, 2002. The annual report for 2002 was filed on January 29, 2003. In addition, the annual reporting requirement has been included in the Company's Regulatory Compliance System, which provides advance notice to Company responsible individuals on specific regulatory reporting requirements.

Summary Recommendation 27
Formulate detailed procedures for pricing transactions under Section 14-4:5.5(t), establish a structured communications and training program for their use, and provide for a formal program of internally verifying compliance with those procedures.

The Company strongly disagrees with this recommendation. All of the Company's pricing and accounting procedures are set forth in the CAM. See the Company's response to Summary Recommendation 13.

Summary Recommendation 28
Formalize a lease agreement between ACE and Atlantic Southern Properties for the May's Landing office building, with the charges to ACE based on the lower of book value or demonstrated market value.

The Company has completed the updated Lease document and it will be executed early in the second quarter of 2003. There was a lease agreement between the parties, which expired in 1999 and the terms of the agreement were renewed without the formal lease agreement - an oversight that is being corrected.

With regard to the recommendation to charge ACE based on the lower of book value or demonstrated market value for the subject lease, the Company has some concerns with the standards. It is the Company's opinion that in the case of a lease such, as the lease arrangement between Atlantic Southern Properties (ASP) and ACE, book value does not necessarily send the appropriate price signal for such transactions. Depending on the particular rental property, the book value could be unrealistically high or low and is not the appropriate benchmark on which to base a lease agreement. In the case of the ASP/ACE lease, the current market price has been determined to be approximately $ 3 million per year based on a recent study developed by Trammell Crow Company ("Competitive Properties For Mays Landing - 2001 and 2002 Market Values") which was completed on January 15, 2003. The current annual lease payments made to ASP by ACE, which were developed using "full-costing" methodology in accordance with the Company's CAM, is approximately $2.1 million.

If the Board is to ultimately adopt this recommendation, the Company will have to make a determination of the appropriate book value and make any adjustments, if necessary, in the context of a rate case.

Summary Recommendation 29
Add the required disclaimer to the Conectiv Energy webpages that mention Conectiv Energy Supply, Inc.

See the Company's response to Summary Recommendation 21.

Summary Recommendation 30

Demonstrate the adequacy of steps to protect the utility from the negative effects of affiliation with unregulated businesses and the continuing sufficiency of utility spending.

The Company believes that adequate protections are already in place to protect ACE from any negative effects of affiliation with unregulated businesses and to ensure the continuing sufficiency of utility spending. See the response to Summary Recommendation 31.

Summary Recommendation 31

Place restrictions on ACE investments in the money pool similar to those required by the Board for JCP&L.

The Company strongly disagrees that this recommendation to place restriction on ACE investments in the money pool similar to those required by the Board for JCP&L is necessary. First ACE already has oversight on its investments by the U. S. Securities and Exchange Commission (SEC) and the New Jersey Board of Public Utilities. ACE is required to publicly file quarterly and annual financial reports with the SEC as well as monthly short-term debt reports with the Board. These reports allow regulators to monitor ACE's short-term borrowing and short-term investment positions. ACE has never borrowed in the short-term debt markets for the purpose of investing in the money pool. Second, PHI (ACE parent company), an investment-grade company, guarantees the deposits of all participants in the money pool, thus substantially mitigating ACE's investment risk. Third, the Liberty consultants failed to consider the Company's request to include the information from a Moody's report that results in a more favorable review of PHI and its operating utilities. The report demonstrates that a different methodology for reviewing the holding company and its operating utilities results in a different (far more positive) conclusion concerning the overall strength of PHI and ACE. Finally, in the event of default by PHI under the credit agreement, there is no cross-default to the utilities - their borrowing capability is not restricted. Thus, ACE, Delmarva Power & Light and Pepco retain their access to the $500 million sub-limit, in aggregate, of the overall PHI credit facility.

II. GENERAL FACTUAL CORRECTIONS TO THE FINAL REPORT

The following are the Company's corrections to factual errors contained in the text of the Final Report.

- On p. 6, in the bulleted list, penultimate bullet, the Report states "Conectiv Energy Holding Company, which provided natural gas . . . ." This statement would be more accurate if modified as follows: "Conectiv Energy Holding Company, which holds subsidiaries that provide natural gas . . . ."

- At the bottom of p. 6, the Report lists PHI's first-tier subsidiaries. The first bullet includes "Conectiv Energy Services, a multi-fuel management and generation company that serves wholesale customers in the Mid-Atlantic." However, there is no legal entity, nor first-tier subsidiary, called Conectiv Energy Services is not. It would be accurate to include the following instead: "Conectiv, a registered public utility holding company, which, during the audit period, was comprised of the entities shown in the organization chart below."

- On p. 9, the report lists the entities that Liberty determined were RCBSs of ACE's PUHC. The third entity in the bulleted list is "Thermal Systems, Inc." The Company believes that was intended to say "Conectiv Thermal Systems, Inc." However, the Company also notes that, based on information it received early last week (and reported to Liberty and referenced in the Report), Thermal Energy L.P. I (TELP) is actually the entity (partially owned by Conectiv Thermal Systems, Inc.) that actually offers and provides the retail services in New Jersey formerly thought to be provided by Conectiv Thermal Systems. Therefore, the Company will modify its Compliance Plan to list TELP as a retail affiliate in lieu of Conectiv Thermal Systems.

- On p. 56, footnote 93 lists certain entities that Conectiv identified as Retail Affiliates. The Company wishes to clarify that that the list of affiliates referred to was included in the Compliance Plan filed in June 2002, not its most recent Compliance Plan, filed in January 2003.

- On p. 124, under Section G.1., the last sentence states "Conectiv Solutions LLC (most of whose assets were sold in April, 2001, and whose remaining contracts are being wound down) . . . ." The Company wishes to clarify that all remaining contracts were terminated in September 2002.